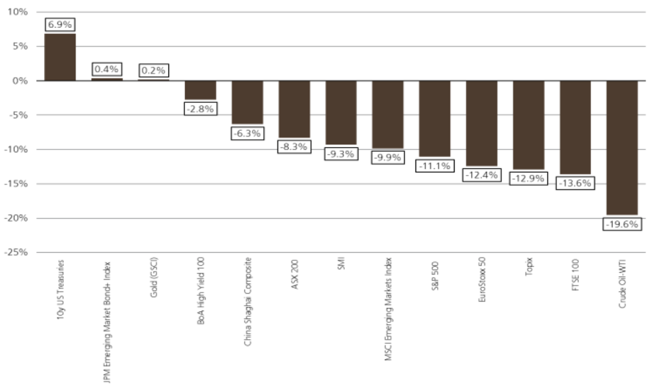
Coronavirus: the market impact

- **The coronavirus continues to dominate global markets as recorded cases outside China grow and economic growth concerns increase**
- **US political risk is also weighing on equities**
- **We believe it is the duration more than the severity of the coronavirus that most threatens global growth and risk assets, any slowdown in new cases would therefore likely represent an important milestone**
- **We acknowledge the distribution of potential global growth outcomes is shifting, but our base case remains that the coronavirus is a transitory not recessionary shock; there is scope for a meaningful rebound in demand and investor confidence**
- **The US has cut rates and we expect the same from Australia, Canada, UK and others in a bid to ease financial conditions and improve sentiment; a coordinated central bank response would be powerful message to markets**
- **Moratorium on China tariffs an obvious move for President Trump to boost re-election chances; scope for fiscal stimulus across major economies too**

What has been happening in markets?

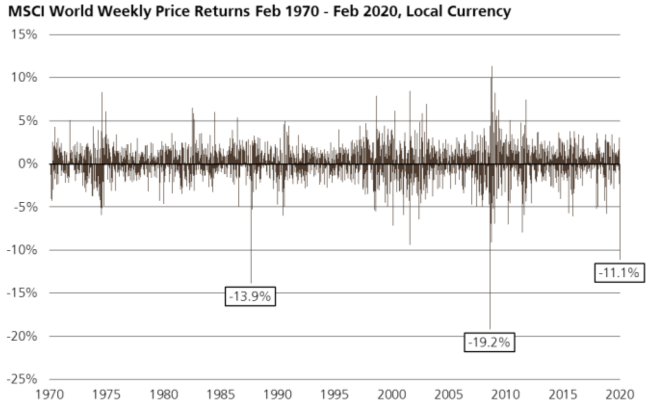
As the number of reported coronavirus cases outside of China continues to rise, so do broader investor concerns about the potential economic impact of the virus. The prevailing market narrative has shifted swiftly from the coronavirus being a predominantly China issue, to the coronavirus being a global problem that might result in recession.

Selected market returns since start of coronavirus: (Jan 17, 2020 - Feb 28, 2020)



Source: UBS Asset Management, Refinitiv as of March 1, 2020

MSCI World Weekly Price Returns Feb 1970 - Feb 2020, Local Currency



Source: UBS Asset Management, Refinitiv as of March 1, 2020

But the repricing of growth expectations and risk across asset classes due to the coronavirus has been far from uniform (Exhibit 1). Industrial commodities, most notably oil, and commodity sensitive equities and currencies have been among the hardest hit. Within equity markets, one of the most notable and surprising features of market price reaction in recent weeks has been the material outperformance of on-shore Chinese equities. Traditional safe havens such as government bonds have outperformed significantly amid the flight to safety, with yields sharply lower and at all-time lows across a number of major countries.

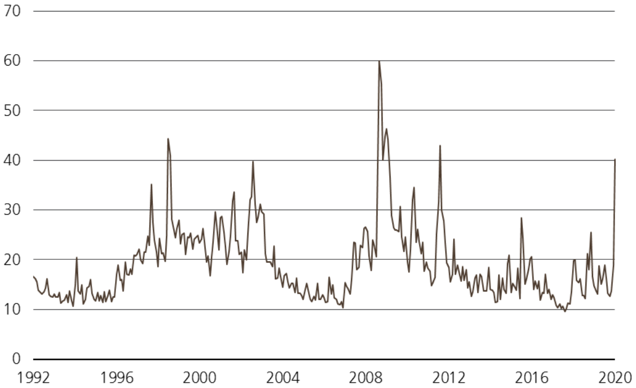
Meanwhile, US high yield bonds in aggregate have fared considerably better than equities in the sell-off despite their sensitivity to a growth slowdown, exposure to consumer spending and usual positive correlation to oil.

To put the scale of last week's market action in an historical context, the weekly fall of over 11% in local currency terms for the MSCI World was the third largest over the past 50 years and the biggest weekly loss since the financial crisis (Exhibit 2). The VIX Index, Wall Street's so-called 'fear gauge', closed the week at levels not seen since the European debt crisis (Exhibit 3).

Are investors over-reacting?

We should acknowledge the high degree of uncertainty that surrounds the potential global economic impact of the coronavirus. That uncertainty is the principal driver of the increase in volatility and the drawdown in risk assets. The transmission mechanisms of the virus to economic demand are nuanced. But in simple terms the potential impact is significant because the virus restricts nearly all parts of the economy via the flow of people and the flow of goods.

CBOE VOLATILITY VIX INDEX



Source: UBS Asset Management, Refinitiv as of March 1, 2020

As the virus spreads further across Europe, US and elsewhere, the probability that it could ultimately lead to a more significant slowdown in global activity is increasing. Efforts to contain the spread of the virus by closing businesses and imposing quarantine are themselves potentially negative to short-term growth potential.

Significant as the potential impact is, we do not yet believe that the virus represents anything like the structural downward shift in global growth that was the result of the financial crisis, but accept that history does not present many helpful guides when it comes to the current scenario.

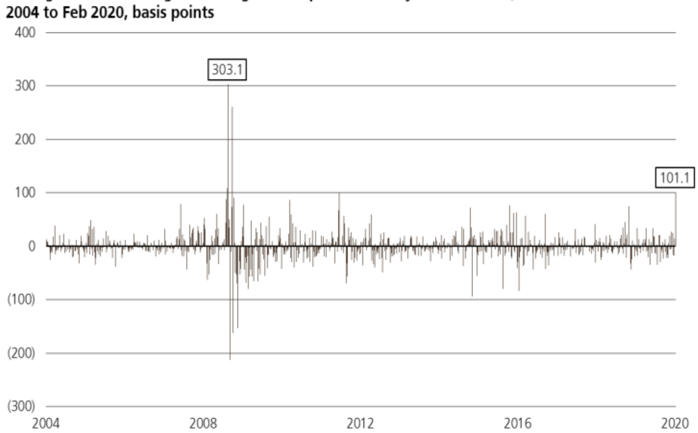
In our view, the dislocation between market reaction in US equities versus US High Yield bonds suggests that strong flows have weighed on equities in particular. Our read through of the relative strength in High Yield is that credit investors do not yet believe that the coronavirus is an event that threatens a more material increase in corporate bond defaults.

Nonetheless, the distribution of potential outcomes for global growth is changing. This mainly reflects the danger that the market sell-off becomes self-fulfilling, with consumer and business behavior materially curtailed by newsflow and by the drawdown in risk assets.

Is it just the coronavirus driving risk assets lower?

In our view, one of the drivers to recent equity falls was the potentially dangerous circularity of the virus and perceived US political risk. Falling equities and any deterioration in economic conditions are likely to boost the chances of a more progressive Democratic Party candidate such as Bernie Sanders winning the US presidency, for which investors are understandably demanding a higher risk premium.

Rolling one week change in US High Yield spread over 10y US Treasuries, Feb 2004 to Feb 2020, basis points



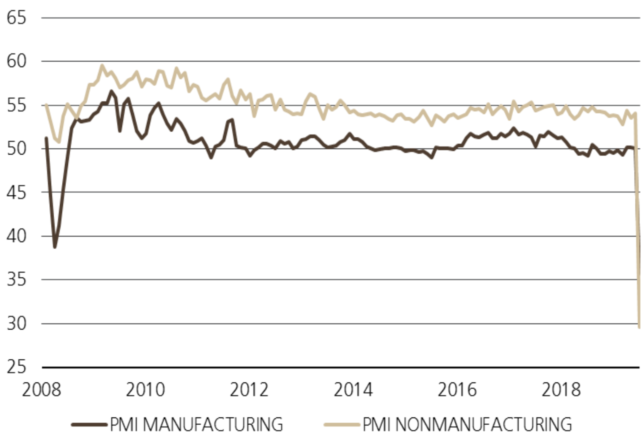
Source: UBS Asset Management, Refinitiv as of March 1, 2020

But the decisive victory of Sanders' principal opponent for the Democratic presidential nomination, Joe Biden, in the South Carolina primary and greater than expected gains for Biden across the 14 primaries of 'Super Tuesday', provide at least a short-term circuit breaker to that negative circularity. Should Biden gain further ground ahead of the July Democratic Convention, investors will begin to unwind some of the risk premium that has been priced in for the threat to corporate profits from the Democratic Party. For all the talk of the coronavirus, perceptions of US political risks are likely to be a major driver of US risk asset returns in the coming months.

How long and how much could the coronavirus impact global economic growth?

We assume for now that the rate of growth in new coronavirus cases in China will continue to slow. But it is not a given. The flash PMIs for February, the first data points we have for a whole month of the virus impact, show Chinese activity across both manufacturing and services slumping to all-time lows with levels significantly lower even than the financial crisis. We currently estimate that annual demand growth in China will be around 50 basis points (bps) to 75bps lower than pre-virus consensus forecasts of 5.8% with the impact firmly focused in calendar Q1 and Q2.

China NBS Manufacturing & Services PMIs



Source: UBS Asset Management, Refinitiv as of March 1, 2020

But we should not forget the secondary economic impact of the coronavirus in China via the disruption to global supply chains. We are likely to hear a lot more about it from global corporates in the coming weeks. According to a recent report (*Business Impact of the Coronavirus – Dun & Bradstreet*) over five million companies globally – and some 94% of the Fortune 1000 – have one or more suppliers in the area of China affected by the coronavirus. China is returning to work and activity levels are rebounding. But as positive as that is, a significant degree of disruption for global corporates is likely for weeks to come.

Outside of China, lower population densities and generally strong public healthcare systems (excluding the US) are likely to limit both the spread of the virus in developed countries and its subsequent mortality rate. But the disciplined and effective response of the Chinese authorities to-date is also at the upper bound of what might be expected in terms of response from any given country.

At a minimum, the continued rise in cases outside of China lengthens the period during which the virus is likely to impact global growth and remain a source of heightened uncertainty to investors. The increase in uncertainty has clear negative implications for overall short-term demand, for forecast corporate earnings – and for the equity multiple that investors are willing to pay for lower profits growth amid such uncertainty in the short-term.

Based on the progression of the virus in China, our view is that the disruption to growth and risk asset volatility are likely to remain elevated well into Q2 while the number of cases in major economies continues to rise. To-date consensus forecasts have cut only around 20bps off global growth expectations for 2020 to around 2.5%, and around 4% off 2020 global earnings growth forecasts (Source: Refinitiv, Citigroup).

We believe it is the length more than the severity of the coronavirus downturn that matters most. If the impact of the coronavirus is still being felt into the second half of 2020, both consumers and corporates are likely to change their behavior and the coronavirus ceases to be a short-term earnings story and starts to become a credit story.

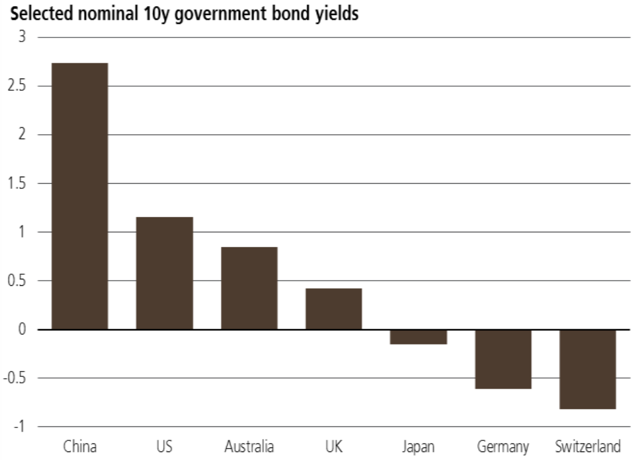
If it is only a few weeks into Q2, we believe that companies and consumer behavior will be held in check over the short-term but the underlying momentum is unlikely to fundamentally change. In those circumstances we see the potential for a strong demand rebound in the second half of the year that is likely to accompanied by a more forceful return in investor risk appetite.

In short, our base case remains that the coronavirus represents a meaningful demand and supply shock, but one that is unlikely to have a structural impact on growth potential or the long-term equilibrium interest rate. While the precise timing of any demand rebound is not easy to pinpoint in the context of the coronavirus, we see sufficient supports to believe that growth momentum will return around mid-year. It has the potential to do so strongly.

What can counter the negative newsflow?

1. **A slowing of new cases in major economies -** would, we believe, represent an obvious but nonetheless important risk milestone for many investors. Based on the experience in China, we believe the high point in new case growth is probably some weeks away as the virus continues to spread. It is self-evident that the development of a successful (and affordable) vaccine would represent the most effective counter to the uncertainty. But industry commentary suggests that this is unlikely in 2020.
2. **Tariff reduction/reversal -** On the face of it, geopolitics remain an additional threat to our base case, most notably in the forthcoming US elections and in the ongoing US/China trade disputes. But it is within the sphere of international trade that we see the greatest probability for a potential upside surprise. President Trump is well aware of the importance of a robust economy and rising stock market to his re-election chances. The lifting of US tariffs on Chinese goods is an obvious lever for the White House to pull in a bid to reverse the negative newsflow of the coronavirus.
3. **Further rate cuts -** In response to the growing threat to growth from the coronavirus, we expect central banks to increase the policy stimulus in a potentially coordinated fashion. Recent statements from the US Federal Reserve and the Bank of Japan very clearly support this view. As well as the recent US rate cut, we anticipate further cuts to key policy rates globally including in Canada, UK and Australia. The recent fall in nominal bond yields further loosens financial conditions globally.
   We would add that even if the lag between stimulus and its impact on the real economy is likely to be longer than usual in developed countries due to the coronavirus, we believe that monetary policy and its accompanying communication retains its power to support sentiment and activity.
4. **Developed economy fiscal stimulus -** We believe monetary policy is also likely to be complemented by an increasing fiscal impulse in a wide range of developed countries including Japan and the UK that can further cushion growth.
5. **Chinese policy stimulus** - Cuts across key market lending rates, the deferral of loan payments for impacted businesses, cuts to social security payments, fee waivers, automatic re-lending and utility subsidies are just some of the measures already put in place to help struggling Chinese businesses. The Chinese authorities have the full suite of potential policy measures at their disposal to further combat the domestic growth slowdown if necessary. We expect more to come across all policy channels, but see the Chinese authorities turning increasingly to fiscal stimulus via tax cuts and increased infrastructure spending.

Selected nominal 10y government bond yields



Source: UBS Asset Management, Refinitiv as of March 1, 2020

What is happening in Investment Solutions portfolios?
With all the industry comment coming into 2020 over the threat to traditional multi-asset portfolios from a structural shift higher in equity/bond correlations, recent days have underlined the critical role that government bonds still have to play in improving the risk-adjusted returns potential of multi asset portfolios.

Within the universe of major global nominal government bonds, our favored market is China. On top of attractive yields on a relative basis (Exhibit 6), we continue to see Chinese government bonds as a very effective multi-asset diversifier in the context of the coronavirus.

The outlook for global equities remains nuanced in a fast changing and dynamic market environment. Global equities remain attractively valued relative to both government and corporate bonds – and we believe that global growth and earnings will rebound in the second half of the year. But in the short-term, the uncertainty around the economic impact of the coronavirus is inconsistent with high levels of portfolio equity risk.

We are therefore focusing on some attractive relative value trades amidst the dislocation – and awaiting better opportunities for higher conviction views on economic cyclicality and equity directionality given the potential for a sharp bounce back. In our view, these are markets that are likely to reward disciplined risk budgeting and diversification.

For Fixed Income, we have reduced credit risk and positioned strategies to benefit from increased demand of high quality sovereign and corporate bonds. Our focus is on developed and emerging markets where central banks still have the scope to manage downside risk through further policy accommodation. We will likely not add any material direct credit risk back into our strategies until we see some sign of stabilization. However, we will look to take advantage of any material increase in credit spread volatility, where feasible.

Within **Global Equity markets** we have seen a clear 'flight to safety' with defensive sectors outperforming cyclical stocks and growth outperforming value. We have already seen a number of companies providing warnings on earnings with areas such as autos, leisure and airlines especially impacted. We are using such short term dislocation to increase holdings where shares have fallen below our estimates of long term value, while being mindful of the risk of further disruption.

For **Emerging Markets Equities**, the short-term economic impact from coronavirus could be significant, largely because of the considerable precautions taken (particularly in China), like travel restrictions and factory closures.

In China, many large companies and state-owned enterprises have resumed work, but smaller companies face more of a struggle. Coal mining, steel and food manufacturing have seen faster pace of work resumption, while less so for travel, tourism and auto-related sectors. Depending on the sector and progression of the Covid-19 situation, it is estimated that the impact of work disruptions could last for one to two quarters.

As for supply chain, even prior to Covid-19, the move to reduce dependence on China had started and Covid-19 provides an additional impetus to diversify. Favored destinations are South-East Asia (esp. Vietnam), India and reshoring, especially back to North America, South Korea or Japan. Restructuring the supply chain is often accompanied by automation, benefitting factory automation companies.

But the outbreak of coronavirus is also accelerating fundamental, long-term changes in consumer behavior within emerging markets. For example, consumers are shifting online for services like after-school tutoring; fragmented industries like real estate and restaurants are consolidating; higher demand for better connectivity is driving investment in IT networks, and healthcare companies are investing in R&D and innovation to deliver new drugs and health services.

Despite the uncertainty caused by coronavirus, we remain confident in these fundamental, long-term changes playing out in emerging markets and our portfolios are focused on quality companies associated with them. That said, we remain cautious and haven't made big moves, but we are holding slightly higher cash reserves should opportunities emerge.

From a **UBS Hedge Fund Solutions perspective**, fundamental strategies may encounter some near term volatility as hedge funds digest the potential economic headwinds related to containment of the virus, but our relatively low net exposure should help mitigate the risk so we can be front footed after the uncertainties are resolved. Our overweight to macro trading and fixed income relative value should provide the opportunity to monetize the volatility created as markets digest the potential recessionary risk and government policy response to the crisis

For **UBS O'Connor**, virus fears and rapid market sell-off have sparked an aggressive bout of de-risking within global equity and credit markets. While diversification and tight beta management has provided defensive characteristics for our strategies, recent flows indicate that hedge funds have entered a more aggressive de-risking phase, which is creating both risk and opportunity for our strategies. We are watching closely for opportunities to add to risk over the coming week, and are focused on those segments of the market where dislocations have been extreme relative to beta performance. We expect markets to begin to normalize over the coming week, as investors increasingly discount the economic impact associated with the virus and a potential policy response becomes apparent to the markets.

Coronavirus is a risk to economies and **real estate markets**, particularly in Asia Pacific, but we believe that any impact will be short term if it is contained. There has been a dip in investment activity and share of international capital flows. We have seen interest rate cuts leading to yield falls in some markets, with real estate pricing around average versus index linked bonds. We do not see a big inflation risk and our analysis suggests that real estate offers suitable inflation protection.

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